No. 305

In the Supreme Court of the United States

OCTOBER TERM, 1967

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

NEW ENGLAND ELECTRIC SYSTEM, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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CITATIONS

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OPINIONS BELOW

The opinion of the court of appeals (A. 48–65) is reported at 376 F. 2d 107.[1] The findings and opinion of the Securities and Exchange Commission (A. 3–28) are reported at 41 S.E.C. 888. An earlier opinion of the court of appeals (A. 29–47) is reported at 346 F. 2d 399. This Court's opinion reversing the court of appeal's first decision is reported at 384 U.S. 176.

JURISDICTION

The judgment of the court of appeals was entered on March 31, 1967 (A. 66). The petition for a writ

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[1] The appendix to the briefs is cited as "A.", and the certified record in *Securities and Exchange Commission* v. *New England Electric System, et al.*, No. 636, October Term, 1965, is cited as "R.".

of certiorari was filed on June 28, 1967 and was granted on October 9, 1967 (389 U.S. 816). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Section 11(b)(1)(A) of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79k(b)(1)(A), permits a public utility holding company to control more than one integrated public utility system only if separation would entail "the loss of substantial economies." In *Securities and Exchange Commission* v. *New England Electric System,* 384 U.S. 176, this Court (reversing the court of appeals, which had set aside the Commission's order) held that the statute is not satisfied by showing that separation will result in a substantial business loss; the economies from retention must be so important that their loss would cause a serious impairment of the separated system. On remand the court of appeals again set aside the Commission's order. The basic question presented is whether, in so doing, the court misapprehended the standard laid down by this Court for interpreting the substantial-economies provision and improperly shifted the burden of proof on the issue of substantial economies from the holding company to the Commission. In addition, we present these specific questions which are facets of the lower court's basic error:

1. Whether the Commission, having found that respondent's study of the added costs of independent operation contained serious deficiencies, was entitled to reject the study in its entirety as providing an unreliable basis for determining whether divestiture of

the gas properties would cause a loss of substantial economies.

2. Whether the Commission, having found on the basis of evidence concerning comparable utility systems that the separated system would have an adequate margin of revenue over costs for successful independent operation, was also required to make a specific determination as to the system's future rate of return and its effect upon the cost and availability of financing.

3. Whether the Commission, in deciding whether a loss of substantial economies would occur, was entitled to consider offsetting advantages that the separated system would likely enjoy by reason of independent operation, without attempting to fix a specific dollar value therefor.

STATUTE INVOLVED

Section 11(b) of the Public Utility Holding Company Act of 1935, 49 Stat. 820, 15 U.S.C. 79k(b), provides in pertinent part:

> It shall be the duty of the Commission, as soon as practicable after January 1, 1938:
>
> (1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, * * *: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if,

after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system * * *.

STATEMENT

Respondent New England Electric System ("NEES") is a holding company registered under Section 5 of the Public Utility Holding Company Act of 1935, 49 Stat. 812, 15 U.S.C. 79e. It controls electric utility companies serving customers in New Hampshire, Massachusetts, Rhode Island and Connecticut and retail gas companies in Massachusetts. In 1957 the Securities and Exchange Commission, pursuant to Section 11(b)(1) of the Act, instituted proceedings to determine (among other questions) whether NEES was entitled to retain the gas companies. Section 11(b)(1) provides that a registered holding company, unless it qualifies for an exception under the statute, may control only a single integrated public utility system. NEES' electric properties have been found to constitute such a system (*New England Electric System*, 38 S.E.C. 193), and NEES has elected to retain them in the event that it cannot also control the gas companies. NEES argued that it was entitled to retain the gas system under the exception provided by Clause (A) of Section 11(b)(1), which permits retention of an additional system that "cannot be operated as an independent system without the loss of substantial economies." After extended

hearings, the Commission rejected this contention and ordered the divestiture of the gas companies, 41 S.E.C. 888; A. 3–28.

When that portion of the proceeding before the Commission dealing with the question of whether NEES could retain its gas companies began, NEES controlled, *inter alia,* seven electric utility companies, eight gas utility companies and a service company. The retail electric companies served 824,000 customers in a franchise area of 4,600 square miles within the States of New Hampshire, Massachusetts, Rhode Island and Connecticut (A. 4). The gross investment in electric plant and equipment, as of December 31, 1958 (the last year for which audited figures were presented), was approximately $600,000,000, and gross revenues from sales of electricity in 1958 were approximately $143,000,000 (A. 4).

NEES's gas subsidiaries provided retail service to 237,000 customers in a franchise area of 660 square miles entirely within Massachusetts. Seventy-five percent of this area was also a part of the franchise area of NEES's electric subsidiaries, and about 78 percent of the gas customers were also served by NEES's electric subsidiaries. As of December 31, 1958, NEES's gross investment in gas plant and equipment was approximately $56,300,000 and gross revenues in 1958 from the sale of gas were $22,700,000 (A. 4–5). Except for manufactured gas used only during peak periods and for emergency standby purposes, NEES sells natural gas obtained by pipeline from the southern United States (A. 5). Of the twelve Massachusetts nonaffiliated gas companies which respondents

selected during the proceedings for comparison with NEES, only one exceeded the NEES gas utility system in size of gross plant, gross annual revenues or number of customers (A. 18, n. 24; R. 1365).

NEES acquired most of its gas subsidiaries between 1926 and 1931. In 1951, "as a step in effectuating compliance by NEES with the integration provisions of Section 11(b)(1) of the Act," NEES proposed to sell its Massachusetts gas properties as a unit and obtained three bids therefor (A. 5, 10 n. 13; R. 48, 70).[2] Although NEES signed a contract for such sale, it was not consummated because the purchaser failed to obtain the anticipated financing (A. 5; R. 48, 70).

Thereafter, NEES abandoned attempts to sell in favor of a long range plan to "develop and promote the natural gas business" (R. 71). William Webster, president of NEES, testified in explanation of this change of policy, that by 1948 its electric business was experiencing a post-war growth, but "we had come to realize that the manufactured gas business had a rather dim future * * *" (R. 68). He said that from 1948 to 1951, NEES was increasingly concerned with difficulties of raising equity capital and since the gas properties were then "contributing little if anything to [NEES's] net earnings," a sale thereof "seemed clearly indicated from an economic standpoint" (R. 69). After the 1952 proposed disposition failed, however, NEES realized that with the advent of natural gas, "gas had a fair chance in the market and could be built up to pull its own weight as a part of the System" (R. 71). The effort to promote and

[2] *New England Electric System*, S.E.C. Holding Company Act Release No. 11016 (1952).

develop NEES's natural gas distribution business "produced results beyond * * * early hopes," with gross operating revenues increasing about 83 percent from 1951 to 1959 and consolidated income from the gas properties rising from $250,000 to $2,100,000 in the same period (R. 73).

The eight gas companies are organized administratively as a gas division with centralized management, marketing and supply, operations, and merchandising departments (A. 5). All of the companies are located within 48 miles of the division headquarters, except one company which is 80 miles away (A. 5 n. 5). The head of the Gas Division is also the president of each gas company and is ultimately responsible to NEES's vice-president in charge of management (A. 5; R. 1305).

In rejecting NEES's contention that the gas system was retainable as an additional system which "cannot be operated as an independent system without the loss of substantial economies * * *" within the exception of Clause (A) of Section 11(b)(1), the Commission found that NEES's estimate of the loss of economies flowing from divestiture was exaggerated (A. 9–14) and that, even accepting *arguendo* NEES's figure, NEES had failed to show a "loss of substantial economies" within the meaning of Clause (A) (A. 16). In so holding, the Commission interpreted the relevant provision, as it had in prior divestment cases dating back more than twenty years, to require a showing that each "additional system cannot be operated under separate ownership without the loss of economies so important as to cause a serious impairment of that

system" (A. 9). Under this test, the Commission ruled, it was unable "to find that the gas companies could not be soundly and economically operated independently of NEES" (A. 25).

In its initial review, the court below set aside the Commission's order on the ground that the Commission had misinterpreted the statutory standard of "loss of substantial economies" (A. 29–47). In that court's view, Clause (A) merely "called for a business judgment of what would be a significant loss" (A. 39). This Court reversed. 384 U.S. 176. It approved the Commission's interpretation, and remanded the case to the court of appeals for "review of the challenged order in light of the proper meaning of the statutory term." 384 U.S. at 179–180.

On remand, the court below again set aside the Commission's order. Proceeding on the premise that the Commission is to be held to a *"most stringent"* standard in evaluating a claim of loss of substantial economies (A. 52), the court identified three areas where, in its view, the Commission's analysis had been deficient.

1. In the proceedings before the Commission NEES had introduced and relied on a cost study, prepared by Ebasco Services, Inc. ("Ebasco"), which purported to show that the gas system would incur some $1 million annually in additional costs of billing, meter reading, accounting and other items if separated from the electric system. The Commission had found that the study was deficient in a number of particulars and generally failed to provide a reliable basis for measuring the costs of independent operation,

especially in view of its inconsistency with the experience of comparable independent gas systems (see *infra*, pp. 21–25, 27–31). The court of appeals, while observing that "[w]e do not necessarily criticize the Commission for its skepticism in the specifics," nevertheless held that the Commission had erred in rejecting the study as a basis for decision and that the Commission should have reduced the Ebasco estimate by some determinate amount and then considered whether the corrected estimate was substantial (A. 54).

2. NEES had argued to the Commission that since gas companies in New England operate on a small margin of revenue over costs—this because of the high cost of gas in that region—its gas system could not afford such added costs as might be entailed by independent operation. The Commission had rejected this contention, noting, among other things, that other gas systems in Massachusetts operate profitably, including those not under common control with electric systems; that the gas system resulting from separation would be the second largest in the region; and that its ratio of costs to revenue—even assuming that the estimate of additional expenses contained in the Ebasco study were correct—would compare favorably with other Massachusetts gas systems. The court of appeals found the Commission's answer inadequate. It held that "the focus must be on the specific characteristics of the NEES companies"—in particular, on whether the rate of return that that gas system would enjoy after separation would be large enough to attract the new investment necessary for the survival and growth of the system (A. 56–59).

3. In finding that NEES's gas system could effectively stand alone, the Commission had relied in part on a presumption drawn from the history and purpose of the Public Utility Holding Company Act and from its own experience that a gas system is more likely to prosper if it is free from the control of a holding company that has interests in a competing business. The court of appeals held that the Commission could not give "independent significance to the generalized competitive advantages" that it had found but must "confine itself to a quantitative analysis of the substantiality of" economies lost (A. 61).

The court remanded the case to the Commission "for further proceedings and an analysis by the Commission responsive to the difficulties which we have set forth" (A. 61).

SUMMARY OF ARGUMENT

Under Section 11(b)(1) of the Public Utility Holding Company Act, the Securities and Exchange Commission is directed by Congress to require each holding company system to limit its operations to "a single integrated public-utility system." As an exception to that general command, the Commission is to permit the retention of control over one or more additional integrated systems if it finds, under Clause A of Section 11(b)(1), that each such additional system "cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system." NEES has both an electric and a gas system, and has elected to retain its electric system. The question here is whether the Commission properly con-

cluded that NEES could not also retain the gas system, because it had failed to show that the gas system cannot be separately operated without the loss of economies "so important as to cause a serious impairment of that system" (A. 9)—the interpretation which the Commission consistently had given to the "loss-of-substantial economies" standard in Clause (A) and which this Court upheld when the case previously was here. 384 U.S. 176.

The determination whether divestiture of an additional system will entail the loss of substantial economies requires the exercise of an informed judgment as to the significance of a number of intangible factors, most of which necessarily are not susceptible to precise dollar evaluation. That determination has been confided by Congress to the Commission, and the agency's conclusion is to be accepted upon review "if it has 'warrant in the record' and a reasonable basis in law" (*National Labor Relations Board* v. *Hearst Publications,* 322 U.S. 111, 131). The Commission's ruling that NEES had not sustained its burden of showing that divestiture of its gas system would entail the loss of substantial economies meets both of those requirements, and the court of appeals should have upheld the divestiture order.

A. NEES relied upon the Ebasco study to show the additional costs that allegedly would result from divestiture. The Commission found that the study had serious deficiencies that rendered it inadequate as a basis for any reliable prediction of such increases. The court of appeals held that the Commission

had improperly rejected the study, on the ground that the deficiencies would only justify the agency in reducing the estimates by some specific amount, but not in rejecting the study completely. But since the holding company has the burden of proving that it is entitled to the exemption that Clause (A) provides from the general prohibition upon retention of more than one system, the Commission is justified in denying an exemption if the company's proof is inadequate; the agency is not itself required to remedy such defects.

The determination whether divestiture will entail a loss of substantial economies calls for analysis of factors that are not susceptible to precise measurement and involves predictions that are necessarily speculative. The Ebasco study, for all its seeming mathematical exactitude, was no more than an attempt to assign dollar consequences to a multitude of business decisions that might—or might not—follow divestiture of the gas system and necessarily reflected a large number of judgment factors. It did not have the certainty that the dollar estimates it contains seem to suggest. In the circumstances, the serious deficiencies in the study found by the Commission justified the agency in rejecting it.

B. On the supposition that NEES presents a unique situation, the court of appeals dismissed the Commission's extensive documented experience with other utility systems, observing that "[c]omparison with figures derived from the situations of other companies in other places at other times cannot be conclusive" (A. 58). Thus the court rejected as immate-

rial the Commission's determination that, even accepting, *arguendo,* the loss of economies predicted by NEES' cost study, the ratios of such loss to revenues, revenue deductions, gross and net income were "lower or not significantly higher than corresponding ratios of gas systems whose divestment we have required on the ground that the estimated loss of economies was not substantial within the meaning of Clause A" (A. 16, 28). Again, the Commission noted that 12 other gas companies in Massachusetts, all but one of which were smaller than the NEES gas system, were able to compete successfully with oil, that the NEES gas system was larger than systems ordered divested in prior cases, and that "several of those systems in turn were larger than companies that had demonstrated conclusively their ability to operate effectively free of holding company control" (A. 18 n. 24). Particularly in light of the necessarily conjectural nature of the forecasts involved, the Commission was properly guided by its knowledge of other public utility systems and its experience with successfully accomplished divestitures in determining that the divestiture of the NEES gas system would not entail a loss of economies so substantial as to cause a serious impairment of the system. Moreover, the legislative history of the Act reflects a congressional recognition that ordinarily only small additional systems would be retainable; NEES is not a small system.

C. In concluding that divestiture would not entail a loss of substantial economies, the Commission took into account the likelihood that the NEES gas system, if freed from control of a holding company that

has a major financial stake in a competing energy source, would realize competitive advantages tending to offset any increased expenses. As this Court noted when the First Circuit's prior decision in this case was before it (384 U.S. 176, 183): "One of the evils that had resulted from control of utilities by holding companies was the retention in one system of both gas and electric properties and the favoring of one of these competing forms of energy over the other." In its present decision, however, the court of appeals held that the competitive advantages of independence were relevant only in interpreting the statutory standard but have no "independent significance" in applying that standard in a particular case. Although the "[c]ompetitive advantages to be gained by a separation are difficult to forecast," they are nonetheless "a matter for Commission *expertise*" (384 U.S. at 184–185), and the Commission was fully justified in taking them into account here.

ARGUMENT

THE COMMISSION PROPERLY RULED THAT NEES HAD FAILED TO ESTABLISH THAT THE DIVESTITURE OF ITS GAS SYSTEM WOULD ENTAIL THE LOSS OF SUBSTANTIAL ECONOMIES WITHIN THE MEANING OF SECTION 11(b)(1)(A) OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Section 11(b)(1) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k(b)) directs the Commission to require every registered holding company to limit its operations to "a single integrated public-utility system." Clause (A) of that Section, however, permits a holding company to retain an ad-

ditional integrated system that the Commission finds "cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of [holding company] control * * * ." Since NEES has elected to retain its electric utility system, the question here is whether the Commission properly ordered divestiture of the gas system because NEES had not established that such divestiture would entail the "loss of substantial economies." In so holding, the Commission applied its settled interpretation that substantial economies were those "so important" that their loss would "cause serious impairment of that [additional] system" (App. 9), and it concluded that the record did not show that "the gas companies could not be soundly and economically operated independently of NEES * * *" (App. 25).

The court below originally held that the Commission's interpretation of Clause (A) was unduly narrow; it construed the Act as requiring only "a business judgment of what would be a significant loss" (A. 39). When this case was here before, however, this Court held that the Commission's interpretation was "well within the permissible range given to those who are charged with the task of giving an intricate statutory scheme practical sense and application" (384 U.S. at 185). The Court also pointed out (*id.* at 180; footnotes omitted):

> The requirement in § 11 of a "single integrated" system is the "very heart" of the Act. The retention of an "additional" integrated system is decidedly the exception. * * *

Since Clause (A) is an exception to the general statutory prohibition upon retention of more than a single system, the burden is upon the company to show that it comes within the exception. See *United States v. First City National Bank of Houston,* 386 U.S. 361, 366. Hence, it is inappropriate to resolve doubts as to the evidence so as to favor the retention of an additional system, or to require the Commission to fill gaps in the company's proof.

The determination whether divestiture of an additional system will entail the loss of economies that are "substantial" in the sense of posing the threat of a "serious impairment" of the system calls for the exercise of an informed and delicate judgment as to the significance of a number of intangible factors, most of which necessarily are not susceptible to precise dollar evaluation. Indeed, even the dollar amount of the additional expenses likely to be incurred upon divestiture cannot be foretold with anything approaching mathematical exactitude, since it, too, involves many intangible considerations (see Point A, *infra,* pp. 18–21). In addition, other factors which cannot be measured with precision must be taken into account before a final evaluation can be made whether there will be a ~~the claimed~~ loss of economies of the significance that Congress intended to treat as "substantial" under Clause (A). These factors include the advantages that are likely to be realized when the gas system is freed from common control with the electric system and is immunized from the possible "favoring of one of these competing forms of energy over the other" (384 U.S. at 183); and the congressional recognition reflected in the legislative

history of the Act that ordinarily large additional systems can be economically operated on an independent basis and are therefore unlikely to be seriously impaired by divestiture (see *infra*, pp. 31–33).

Thus, the nature of the judgment the Commission is required to make in deciding whether an estimated loss of economies resulting from divestiture is "substantial" within the meaning of Clause (A) necessarily involves the application of the skill and experience the agency has acquired in its many years of administering the Public Utility Holding Company Act. Indeed, this Court explicitly recognized, when the case was here before, that the evaluation of the "[c]ompetitive advantages to be gained by a separation [of gas and electric systems] * * * is a matter for Commission *expertise* on the total competitive situation * * *" (384 U.S. at 184–185). No less "a matter for Commission *expertise*" is the making of the ultimate judgment whether, in all the circumstances, the particular projected loss of economies will be "substantial," and judicial review of that determination necessarily is limited. The Commission's determination that an alleged loss of economies would not be substantial—like an agency's "application of a broad statutory term" to a particular factual situation—"is to be accepted if it has 'warrant in the record' and a reasonable basis in law" (*National Labor Relations Board* v. *Hearst Publications,* 322 U.S. 111, 131; see, also, *Gray* v. *Powell,* 314 U.S. 402, 411–412; *Atlantic Refining Company* v. *Federal Trade Commission,* 381 U.S. 357, 367–368). The Commission's ruling that NEES had not shown that divesti-

ture of its gas system would entail the "loss of substantial economies" meets both of those requirements, and the court of appeals should have upheld the divestiture order.

A. THE COMMISSION WAS JUSTIFIED IN REJECTING THE ESTIMATE IN THE EBASCO STUDY OF THE ADDITIONAL EXPENSES THE GAS SYSTEM WOULD INCUR UPON DIVESTITURE, AND WAS NOT REQUIRED ITSELF TO SUPPLY A MORE ACCURATE ESTIMATE

The court below held that the Commission could not reject the Ebasco estimates of loss without making substitute forecasts of its own. It stated: "We do not necessarily criticize the Commission for its skepticism in the specifics; but we do think that even taken together these items constitute at most a basis for reducing the estimated figure by some amount, not for concluding that no increased costs have been proved. In fact, the record here demonstrates conclusively that *some* increased costs are inevitable—the only doubt possible concerns the amount." (A. 54)

Since the basic policy of the Act is against the retention of additional systems and the burden of establishing an exception is upon the holding company, even conclusive proof of some increased costs does not begin to meet that burden. As the Commission observed, "Congress was aware that some loss of economies would usually result from the separation of jointly controlled utility systems" (A. 8). The critical question before the court of appeals on this aspect of the case was whether the deficiencies in the Ebasco study justified the Commission in rejecting it as a basis for any reliable estimate as to the amount of ad-

ditional expenses likely to be incurred upon divestiture. We submit that the Commission was fully warranted in rejecting the study.

1. In our view the attribution of certainty to forecasts of losses of economies that might be caused by separation is illusory. We recognize that there are areas where economies of scale are indeed subject to relatively precise estimates by experts in the utility business. For example, construction and operation costs of generating units—whether using fossil fuel or atomic energy—may be projected with sufficient certainty clearly to demonstrate the cost advantages of relatively large rather than smaller units. Again, analysis of differing peaks of demand in different distribution areas which can be served by inter-connected facilities may point to clearly demonstrable savings from coordinated operations.[3]

But in measuring economies of scale attributed to common management of unrelated operating properties, no comparable certainty is possible. Here the estimate necessarily involves a complex analysis with numerous opportunities for errors of judgment at every step. The first step is to ascertain the cost of operating under the existing combined management. The Ebasco study assumed as a starting point the op-

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[3] Savings of this character are not only readily demonstrable but are consistent with the economic philosophy of the Act, in view of the primary statutory objective of limiting each holding company to a single integrated system. As this Court noted: "Promotion of 'economy of management and operation' and 'the integration and coördination of *related* operating properties' * * * is a theme that runs throughout the Act" (384 U.S. at 182–183).

erating expenses of the gas system per books—but these book operating expenses reflected numerous allocations by the NEES management of joint costs as between electric and gas companies. "Allocation of costs is not a matter for the slide rule. It involves judgment on a myriad of facts. It has no claim to an exact science. Hamilton, Cost as a Standard for Price, 4 Law & Cont. Prob. 321."[4] *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 589.

A second step in forecasting the consequences of severance is to predict what steps, at what cost and at what advantage, the future management may take after severance. Among the questions posed are: What new personnel will be hired at what salaries? Where separation results in a new individual performing only part of the function of a predecessor engaged in the former combined operations, will the new individual have surplus time and energies to devote to other purposes? If so, what advantages will accrue to the separated operation? Where the combined operation has shared office space, equipment, accounting or other facilities or services, can continued sharing be arranged on a contractual basis between the managers of the separated businesses? If not, can comparable joint arrangements be negotiated with other parties? Finally, what advantages may accrue from decision-making by a management freed from the influence presented by a large stake in a competing business?

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[4] As Hamilton aptly observes, "No accountant has been able to devise a method yielding by-product or point-cost figures which does not embody a dominance of arbitrariness and guesswork." See 4 Law & Cont. Prob. 321, 328.

The Ebasco severance cost study attempted to give in elaborate detail dollar-cost answers to such questions, including projected positions and salaries for future employees of the severed gas utility properties. Essentially, the study represented nothing more than the projected results of a multitude of separate assumptions as to business decisions which might or might not be arrived at after severance, although the reduction of these projections to precise figures suggests greater certitude. In fact, there may be a wide disparity between such a hypothetical aggregate and the actual results of decisions by those who would have the responsibility for operating the business as profitably as possible.[5] Thus, even a study of this type that had no specific deficiencies would be subject to the basic infirmity that, because it consists of an aggregate of interrelated value judgments on many factors, tangible and intangible, it necessarily does not have the certainty that the precise dollar estimates of additional costs seem to suggest.

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[5] Forecasts of loss of economies on severance are the counterpart of expected economies from combinations, an area in which business estimates have proved notoriously unreliable. This was recognized in an authoritative treatise when the Act was passed. See Dewing, *Financial Policy of Corporations* (3d ed. 1934) 740–775, comparing results and expectations for the industrial combinations in the period from 1897 through the early 1900's. For current illustration, see Biggs, "Day of Reckoning—Conglomerates Can't Keep Making Two Plus Two Equal Five Forever," *Barron's*, April 3, 1967, p. 3:

> According to a recent study * * * of acquisitions made between 1960 and 1965, in retrospect 36% were admitted to be mistakes. The key word is "admitted", since the interviewers detected a defensive reticence in certain other cases.

2. The Commission did not question the general relevance of the Ebasco study, but did find serious deficiencies which undermined its reliability. The study was originally prepared as a study of the aggregate of the loss of economies to each gas company if each should be required to operate independently. In a supplemental report Ebasco had attempted to readjust its study to allow for the hypothesis that the gas system would be divested as a unit, which was all that the Commission required. Ebasco concluded that the savings from operating the eight gas companies as a unit rather than separately would be not more than approximately $400,000,[6] leaving approximately $1,100,000 of its original $1,500,000 estimate as the loss of economies attributable to requiring the gas division to be separated from the electric companies.[7] This two step approach gave further op-

[6] The figure in the text is that used in the second opinion of the court below and reflects a $67,000 adjustment for increased charges from the service company as permitted after the Ebasco estimate had been prepared. The Commission's opinion and the first opinion of the court below both refer to the lower figure in the actual Ebasco estimate without this adjustment (A. 10 n. 13, 38 n. 8).

[7] If one accepts the relevance of small size as a criterion of retainability under Clause (A) (see *infra*, pp. 30–33), it may seem somewhat incongruous that more than 70 percent of the $1,500,000 aggregate was attributed to the claimed disadvantaged of requiring a $56,000,000 (gross asset) gas business to stand on its own feet and only about 30 percent to further break-up of the gas system into eight separate smaller units. A partial explanation of the paradox stems from the fact that respondent's claim to satisfy the requirement of Clause (A) rests primarily on the supposed advantages of combined operation of gas and electric operations serving the same areas, however substantial each of the operations may be.

portunity for exercise of judgment: first, in estimating the consequences of fragmentation into eight separate gas companies and then in revising that estimate for possible savings on the alternative hypothesis that the present combined operations of the gas companies will continue after severance.

The Commission noted that the changed basis of the study—from assumed fragmentation of the gas system to assumed divestment as a unit—did not result in any change at all in the $415,600 estimate of increase of customer accounting costs (A. 12). Specifically, NEES urged that there could be no advantages from combined billing over the estimated cost of separate billing by each of the eight companies of the 237,000 customers in a compact area. The Commission disagreed (A. 13), pointing out that "respondents have not given any satisfactory reason why at least some form or forms of combined billing procedure could not be employed advantageously by the gas companies, in light of the fact that their aggregate of 237,000 customers is located in a relatively compact area." In addition the Commission found "inadequately explained and casting doubt on the estimates * * * the disparity between the increases attributed to the gas companies and those attributed to the electric companies" (A. 13–14). For example, in the case of the gas and electric companies serving Northampton, of the total cost of jointly performed customer's accounting, $17,000 or $2.12 per customer had been allocated to the gas company and $34,200 or $3.60 per customer had been allocated to the electric company; the projected post-severance cost for the gas company alone

would allegedly increase 184 percent to $6.03 per customer, or a total of $48,400, whereas that of the electric company would allegedly increase only 13 percent to $4.05 per customer. The Commission pointed out that there were similar discrepancies as to projected changes in total treasury and accounting payroll costs of the two Northampton companies and also with respect to the customer's accounting and payroll costs respectively of the two companies serving Lynn. The Commission noted: "These areas of expense, in general, are related to the number of customers served and not the type of utility business conducted" (A. 14).[8]

The Commission further pointed out, as summarized in the opinion below, that "the estimated additional salaries and/or positions for the top executive staff of the gas system were also suspect" (A. 53–54). As to the losses claimed to be attributable from termination of affiliation with the NEES service company, the Commission referred to its prior decisions rejecting similar claims, noting (A. 15 n. 20) that it had previously stated that:

> "to accept an estimate of present benefit from services rendered by system service companies as a measure of economies which would be lost as a result of independence requires us to assume that financial severance will cast operating units completely adrift, incapable of pro-

[8] It was not necessary for the Commission to determine whether this disparity flowed from an existing unfair allocation of costs as between electric operations and gas operations or merely from an exaggerated estimate for the future. "Losses" attributable to either cause will not actually be incurred and obviously are not pertinent to the requirements of Clause (A).

viding themselves with comparable benefits as cheaply either directly or through mutual arrangements with other operating units. We cannot make that assumption."

Having failed to submit a study that provided a satisfactory basis upon which the Commission could predicate a finding that the economies to be lost upon divestiture would be so important as to cause serious impairment of the gas system, NEES did not sustain its burden of showing that the additional system was retainable.[9]

3. In a portion of its first opinion (A. 42), reasserted in the second (A. 54), the court below had stated:

> We have serious doubts as to the extent that the Commission is entitled to disregard an opinion on a matter obviously requiring expert, specialized knowledge with no further evidence before it than what had been considered by the accepted expert. * * * This is not a matter on which a body having such broad jurisdiction

[9] The court below held that the Commission erred in imposing too heavy a standard of proof upon respondent (A. 54 n. 3). This criticism relates to the Commission's statement "that a registrant seeking to retain an additional system has the burden of showing by clear and convincing evidence that such additional system cannot be operated under separate ownership without the loss of economies so important as to cause a serious impairment of that system" (footnote citations omitted) (A. 9). Whatever the general significance of the distinction between "clear and convincing evidence" and "a fair preponderance of the evidence" in resolving factual disputes on the basis of conflicting testimony, we believe the distinction has no relevance to a respondent's burden under Clause (A), where the issue is primarily as to matters of opinion and as to whether, upon otherwise undisputed facts, a case has been made out for exception from the primary policy of the Act.

> as the Commission can have detailed expertise upon which to base affirmative findings. Compare *Market St. Ry. v. Railroad Commission,* 324 U.S. 548, 560. * * *

Market Street Railway, which the court below apparently considered distinguishable, supports the power of the Commission to reject, even in the absence of conflicting testimony, such estimates as were contained in the Ebasco report. There, in rejecting the contention that an order of a State public utility commission reducing rates was invalid because not based on expert testimony as to the effect of the reduction on the volume of traffic, the Court stated, 324 U.S. at 560: "Experts' judgments, however, would not bind the Commission. Their testimony would be in the nature of argument or opinion, and the weight to be given it would depend upon the Commission's estimate of the reasonableness of their conclusions and the force of their reasoning."

Respondents urge (Br. in Opp., p. 15) that the Commission "cannot fairly be expected to have detailed expertise" as to such matters as "the practicability of combined customer billing," and that the agency, therefore, was required to accept the estimates on these issues contained in the Ebasco report. But the Commission's broad experience in the administration of the Holding Company Act qualified it to evaluate the overall reliability of the Ebasco study—a study which by its very nature involves "argument or opinion." If the Act is to accomplish its purpose, the Commission should neither be required to remedy the deficiencies in the holding company's proof, nor be limited in its power to reject estimates which it finds

unconvincing and which rest upon as many imponderables as those presented by NEES, merely because cast in the form of expert testimony.

B. THE COMMISSION WAS JUSTIFIED IN CONCLUDING THAT, EVEN ACCEPTING *ARGUENDO* THE EBASCO ESTIMATE OF INCREASED EXPENSES UPON DIVESTITURE, SUCH INCREASE WOULD NOT CONSTITUTE THE LOSS OF SUBSTANTIAL ECONOMIES

1. The assumption by the court below that experts in the business can forecast with accuracy losses from severance of an additional system is, we believe, at the root of that court's rejection of the Commission's comparative evaluation of the claimed loss of economies. After detailing its reasons for rejecting the Ebasco forecasts, the Commission stated (A. 16):

> Even were we to accept the $1,098,600 estimate of loss of economies to the NEES gas companies, it would not lead us to conclude that such a loss is so substantial, when compared with the loss of economies involved in prior divestment cases and viewed in light of the objectives of the Act, as to warrant retention of the gas properties under common control with the NEES electric system. * * *

Thus the Commission, accepting *arguendo* the Ebasco cost estimates, proceeded to show that other utilities had prospered under like circumstances, and that there was no evident reason why the NEES gas system should not do as well. The court dismissed the Commission's analysis with the observation that "[c]omparison with figures derived from the situations of other companies in other places at other times cannot be conclusive" (A. 58). We believe, on the contrary, that given the highly conjectural nature of the predic-

tions involved, the Commission must be guided by its knowledge of other public utility systems and its experience with successfully accomplished divestitures—that is to say, by the very stuff of its expertise.

The Commission used the Ebasco figure for comparative purposes in applying the statutory test of substantiality, computing the percentage relationship thereof to operating revenues, expenses and income, as it had consistently done in prior decisions under Clause (A). The Commission noted that the claimed loss of economies amounted to 4.83 percent of operating revenues, 6.03 percent of operating expenses and 29.94 percent of net income before taxes (A. 16). The court below apparently considered as significant only the ratio of the forecast losses to net income—as the measure of the assumed loss to investors (see A. 57–58). But the wide disparity between the ratio of the claimed loss of economies to net income and the much lower ratios to operating revenues and expenses are indicative of how misleading it is to give conclusive weight to such a forecast in the light of the other factors which the Commission noted in reaching its overall conclusion.

This may be illustrated by reference to a schedule of consolidated income for the gas companies for the year ended December 31, 1960 (Respondent's Exhibit No. 87A, R. 1352). The schedule shows consolidated total operating revenue of $27,221,026 for the gas subsidiaries. The Ebasco forecast rested on the assumption that severance would result in no improvement in operating revenues. If, contrary to this assumption, the increased expenditures from employing the addi-

tional personnel assumed by Ebasco, or the more vigorous competition with the electric companies which severance would permit, should result in an increase of operating revenue by only two percent of the 1960 figure, or $544,000, that would offset approximately half of the estimated loss. The 1960 figure for consolidated operating expenses, excluding taxes, amounted to $20,230,333. Ebasco forecast in effect that this would be increased by $1,098,600 to $21,300,000. If the actual expenses were only three percent (or $639,000) less than this total figure, this also would wipe out more than half of the estimated loss.[10]

After summarizing the pertinent ratios, the Commission stated: "These ratios are lower or not significantly higher than corresponding ratios of gas systems whose divestment we have required on the ground that the estimated loss of economies was not substantial within the meaning of Clause (A)" (A. 16). The court of appeals, after accepting as "undeniable" that evaluation of losses of economies must be in relation to total revenues, expenses and income, added: "But we observe further that, where the statutory test of substantiality is understood in terms of potential harm to the investor and consumer, even these ratios are significant only as they affect the investment structure of the companies in the particular case, and different companies may be compared only on the assumption that both operate at the same level" (A. 57).

[10] We recognize that there are major elements of the total expense such as plant depreciation and cost of purchased gas over which management would have relatively little control.

The court then rejected the Commission's comparison of ratios in other cases where divestment was ordered, because it assumed that NEES's situation was unique (A. 58). On the assumption that it was dealing with certain and harsh consequences to investors, the court below thought respondents had made out a special case for leniency because in New England wholesale costs of natural gas are high and competition with fuel oil more difficult than in other parts of the country (A. 56).[11] The Commision, however, had noted that this is a problem common to all companies operating in New England and that other New England gas companies of comparable size had apparently been able to operate and "earn a fair return without the alleged advantages of common control with electric utilities by a holding company" (A. 17).

2. The Commission pointed out (A. 18 n. 24):

> Of 12 nonaffiliated Massachusetts gas companies which respondents selected for comparison with NEES, only one exceeded the NEES gas utility system in size of gross plant, gross annual revenues, and number of customers. It may also be noted that the NEES gas system is substantially larger than systems we have ordered divested in prior cases, such as those whose pertinent data are set forth in the Ap-

[11] The marginal character of the natural gas business in New England can easily be exaggerated. Although costs were high compared to other sections of the country, NEES recognized that the advent of natural gas resulted in tremendous improvement in the profitability of its gas operations compared to the situation that prevailed when only manufactured gas had been available (see *supra* p. 6).

> pendix table. We found that several of those systems in turn were larger than companies that had demonstrated conclusively their ability to operate effectively free of holding company control. * * * [12]

The court of appeals rejected the relevancy of the first comparison on the ground that the fact "that the NEES gas companies together would be the second largest system in Massachusetts is a descriptive, not an analytical proposition," which "offers little help in assessing ability to survive" (A. 57).

Contrary to the view of the court of appeals, the fact that other non-affiliated gas companies in Massachusetts, all but one of which were smaller than the NEES gas system, have been able to operate successfully, was highly relevant in determining whether the NEES system, if divested, would also be able to do so. Nor is it surprising that other gas companies and other systems that the Commission had ordered divested, both of comparable size to the NEES system, have functioned effectively without holding company control. For the legislative history of the Public Utility Holding Company Act reflects congressional recognition that ordinarily it would only be in the case of small companies that a holding company could show "a real economic need" for retention of an additional system (H. Rep. No. 1903, 74th Cong., 1st Sess., 71).

[12] In this regard the Commission cited *Philadelphia Co.*, 28 S.E.C. 35, 46–47; *Middle South Utilities, Inc.*, 35 S.E.C. 1, 11.

The Federal Trade Commission concluded its monumental study of public-utility holding companies—a study referred to in Section 1 of the Act—with a chapter concerning "Advantages and Disadvantages of Holding Companies to the Public." See S. Doc. 92, 70th Cong., 1st Sess., Pt. 72-A, 831 (1935). This summary pointed out that, apart from situations where the holding company might be responsible for the "development of connected operations * * * [and] the employment of larger and more efficient production plants," the strongest case for the holding company relationship rested on its ability to provide more expert and economical management for smaller companies (*id.* at 834). "Small, weak companies manifestly might benefit by association of interests, if they were placed in trustworthy and capable hands." *Id.* at 835.[13]

In its prior opinion in the case this Court quoted Senator Wheeler's statement that Section 11 was designed to permit the retention of additional systems that "were so small that they were incapable of independent economical operation * * *" (384 U.S. at 181, quoting 79 Cong. Rec. 14479). See, also, *North American Co.* v. *Securities and Exchange Commission,* 327 U.S. 686, 697, where the Court stated that

[13] See, also, the statement of Representative Wadsworth, an opponent of the Act, who criticized the prospective breakup of the Electric Bond & Share system (which he apparently believed—mistakenly—in 1935 still was a corporate vehicle for providing unified management to many small operating companies), on the ground that "[t]he chief injury is to the little operating company * * * ." 79 Cong. Rec. 10373.

Section 11 permits retention of only those additional systems that are "relatively small."

The NEES gas system is not small. As appears from the unchallenged portion of the Commission's findings, NEES provides gas service to about 237,000 customers in Massachusetts in an area of 660 square miles with a population of approximately one million (A. 4). The gross revenues from the sale of gas were $22,700,000 in 1958, the last year for which audited figures were available (A. 5). The Commission was justified in concluding that the gas system was not so small that it could not be divested without serious impairment to its economic health.

3. Despite the soundness of the Commission's conclusion that the ability of other Massachusetts companies to operate profitably undermined the significance of the Ebasco forecasts, the court below considered that it was the Commission's responsibility to address itself to the more remote consequences for future operations of the loss of net income and a correspondingly reduced rate of return on rate base. The court below would require the Commission to consider as "relevant factors" whether the consequence will be to render the raising of equity capital "difficult or impossible; * * * to raise the cost of borrowing money a little or a lot"—and if rate increases resulted whether they would "injure deeply, hurt slightly, or affect not at all the companies' ability to survive" (A. 5). The court below did not intimate whether in making such determinations the Commission could rely upon its own expertise, or would be limited to making the determination on the basis of expert testimony. In either

event the Commission would be wrestling with uncertainties far greater than those inherent in the forecasts themselves, and if this matter were to be resolved upon the basis of expert testimony the potentiality of delay would be considerable. Respondent had not attempted to address itself before the Commission to these remote consequences of the alleged loss of economies.[14] To require the Commission to do so would inject into Section 11(b)(1) proceedings a host of difficult and time-consuming rate-making issues, and in significant degree would shift the burden of proof in such proceedings from respondents to the Commission.

C. IN HOLDING THAT DIVESTITURE WOULD NOT ENTAIL THE LOSS OF SUBSTANTIAL ECONOMIES, THE COMMISSION PROPERLY GAVE SIGNIFICANT WEIGHT TO THE COUNTERVAILING COMPETITIVE ADVANTAGES THAT AN INDEPENDENT GAS SYSTEM WAS LIKELY TO HAVE

As this Court noted when the case was here before (384 U.S. at 183): "One of the evils that had resulted from control of utilities by holding companies was the retention in one system of both gas and electric properties and the favoring of one of these competing forms of energy over the other." The Court expressly

[14] Respondent itself urged before the Commission the impracticality of an attempt on the part of a holding company to address itself to the ultimate consequences of the claimed loss of economies, stating:

> Respondents have not attempted to argue that the NEES gas companies are incapable of independent operation in any absolute sense which could be mathematically demonstrated, simply because the question, particularly over any significant period of time, is inevitably affected by too many imponderables to be capable of mathematical demonstration. [Respondents' Reply Brief before the Commission, p. 37.]

noted that the Commission in this case had "found that any losses of economies would be offset by the benefits that would flow from the healthy competition between the independently controlled gas and electric companies" (384 U.S. at 179) and commented (*id.* at 184–185):

> Competitive advantages to be gained by a separation are difficult to forecast. The gains to competition might well be in the public interest and might well offset the estimated loss in economies of operation resulting from a separation of the gas properties from the utility system. This is a matter for Commission *expertise* on the total competitive situation, not merely on a prediction whether, for example, a gas company in a holding company system may make more for investors than a gas company converted into an independent regime.[15]

The court below quoted this language (A. 60), but in disregard of its clear import held that the advantage of competition is something the Commission is "entitled to take * * * into account as justifying a stringent test of 'substantiality.' But, that done, the general judgment has no independent significance in an individual case" (A. 61).

The language of this Court, quoted above, makes clear that offsetting benefits are relevant not merely to the formulation of the statutory standard for determining when the loss of economies is substantial—as the court of appeals suggested in its second opinion—

[15] Since this issue was squarely presented, and in our view squarely decided, when this case was last before the Court, we do not repeat here the arguments contained in our brief in No. 636, October Term, 1965, at pp. 34–38.

but to the application of the standard in a particular case as well.[16] Nor is it tenable that the Commission can take such benefits into account only in a case where they can be translated into a precise dollar figure. Such a requirement is impossible to comply with; to impose it is to deny any role to offsetting benefits. The requirement is also unsound. That the benefits of free and independent competition cannot be reduced to a dollar amount does not make them insubstantial or unworthy of consideration. A value judgment is indeed required, but that is precisely the kind of judgment which this Court on its earlier review of this case stated the Commission was empowered to make. In reading this factor out of Holding Company Act cases, the court below has refused to give effect to the policy of the Act and to the principles announced by this Court when the case was last here.

Once it is recognized that in weighing a holding company's claim to retain both electric and gas systems the Commission can give independent weight to intangible offsetting benefits of competition, we submit that this factor eliminated any possible doubt as to

[16] The Commission noted that seven Massachusetts gas companies that were not under common control with the electric companies had lower rates but significantly higher sales and revenues per customers than NEES; pointed out that "the determinations respecting the basic interests of the gas companies are made by NEES officials who occupy a dual position in which they must weigh the needs and objectives both of those companies and of the electric companies which represent the principal and most profitable business of the NEES system"; and concluded that it could not state "that a management solely interested in and devoted to the gas companies would not be able to advance them more effectively" (A. 20-21).

the validity of the Commission's conclusion that divestment of the NEES gas system would not entail the loss of substantial economies. On the undisputed facts, the Commission's decision was well within the area of a reasonable exercise of discretion, particularly in view of (a) the size of the NEES gas system, (b) the fact that such a substantial proportion of the economies claimed to be lost on severance were economies allegedly inherent in having common ownership of sizable gas and electric properties serving the same area, and (c) the inherent uncertainty of predicting loss of economies in the circumstances.

CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded to that court with instructions to affirm the Commission's order.

Respectfully submitted.

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